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Invested in America

November 26, 2012

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Gary K. Van Meter, Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102

Alfred M. Pollard, General Counsel
Attention: Comments/RIN 2590-AA45
Federal Housing Finance Agency
Fourth Floor, 1700 G Street, N.W.
Washington, DC 20552

Re: Margin and Capital Requirements for Covered Swap Entities, Board Docket No. R-1415, Docket No. OCC-2011-0008, FDIC RIN 3064-AD79, FHFA RIN 2590-AA45, FCA RIN 3052-AC69

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to submit these comments to the Agencies[2] on the above-captioned rule proposal (the "**Proposed Margin Rule**") in response to the reopening of the comment period for the Proposed Margin Rule and the Agencies' invitation for interested parties to comment concurrently on the Proposed Margin Rule and the Consultative Document entitled "Margin requirements for non-centrally-cleared derivatives" (the "**Consultative Document**")

1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("**GFMA**"). For more information, visit www.sifma.org.

2 As used in this letter, the "**Agencies**" refers to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Farm Credit Administration.

published by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**").[3]

The Agencies explain that, as part of the international efforts to implement consistent global standards for non-centrally-cleared derivatives, the Agencies intend to consider the final policy recommendations set forth by the BCBS and IOSCO when adopting final U.S. rules for margin for non-cleared swaps. Our members fully support the Agencies in their efforts, through BCBS and IOSCO, to seek to establish internationally harmonized margin rules.

However, we strongly urge the Agencies, to the extent they wish to depart from the Proposed Margin Rule based on the final BCBS-IOSCO policy recommendations, to re-issue their proposal so that U.S. market participants have sufficient opportunity to comment on any material changes to the Proposed Margin Rule, consistent with the Agencies' obligations under the Administrative Procedure Act. In particular, it is critical that market participants have the opportunity to evaluate any such changes fully through a review of revised rule text and an updated cost-benefit analysis. Pending a re-issued proposal, we have attached a copy of our comments on the Consultative Document, which we request that the Agencies take into account as part of their further consideration of the Proposed Margin Rule. As we note in the attached comments, the proposals from the Consultative Document raise a number of very significant economic, macroprudential and prudential issues.

We would be pleased to provide further information or assistance at the request of the Agencies or their staff. Please do not hesitate to contact the undersigned if you should have any questions with regard to the foregoing.

Respectfully submitted,

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy
SIFMA

[3] 77 Fed. Reg. 60057 (Oct. 2, 2012).

September 28, 2012

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
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Sent by email to: baselcommittee@bis.org

Secretariat of the International Organization of Securities Commissions
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Re: Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the captioned consultative document (the "**Consultation**") issued by the Working Group on Margining Requirements (the "**WGMR**") of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). SIFMA welcomes the attention of BCBS and IOSCO to the international harmonization of margin requirements for non-centrally-cleared derivatives.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("**GFMA**"). For more information, visit www.sifma.org.

I. OVERVIEW

Margin requirements for non-centrally-cleared derivatives are a key component of the overall reform program initiated by the Group of Twenty ("**G-20**") in 2009. These requirements will potentially have a significant impact on users of non-centrally-cleared derivatives and derivatives market intermediaries and, as a result, the real economy. These impacts will be felt both in times of market stability and, likely with even greater effect, in times of market stress. Our members believe it is critical that international supervisors adopt margin requirements that are consistent and effectively balance financial stability with liquidity and cost trade-offs. We strongly support the efforts of the WGMR to accomplish these objectives.

We agree with the WGMR that margin requirements for non-centrally-cleared derivatives can have important systemic risk mitigation benefits. We also welcome the WGMR's recognition that these benefits must be considered in relation to the reduced liquidity that would result from derivative counterparties' providing liquid, high-quality collateral to meet these requirements. These impacts must, however, be considered in the context of the cumulative impact and interrelationship of other core components of regulatory reform that also have potentially significant liquidity impacts.

These other core components include increased capital requirements, heightened liquidity requirements and single counterparty credit limits. Consider, for example, that new credit value-adjusted capital charges are required to capture dynamic changes in counterparty creditworthiness. Or that expected future exposure computations must be calibrated based on stressed inputs. Increased asset value correlations also capture market stress impacts on asset correlations. Heightened exposure assessments for capital purposes are also now required to capture and reflect wrong-way risk. Significant increases in centrally-cleared swaps arising from mandatory clearing and related margin and guarantee fund requirements will also place further significant demands on market liquidity. And, single counterparty credit limits impose limits on interconnectedness. In fact, both margin rules and counterparty exposure limits address the same issue – counterparty risk. Therefore, we believe that margin rules should be a fundamental component of counterparty rules and should not be written or implemented as independent requirements.

These regulatory proposals in some ways mitigate systemic risk and, cumulatively, also create enormous demands for effective sequestration of liquid assets. As such, new rules and regulations form part of a comprehensive supervisory mosaic that must be viewed holistically to avoid drastically reducing market liquidity, raising transaction costs significantly for end-users, and ultimately limiting the supply of credit to the real economy.

With these considerations in mind, we support the Consultation's proposal to require the full two-way exchange of variation margin between financial firms and systemically important non-financial firms. We believe that the daily two-way exchange of variation margin between these firms will enhance financial stability, while also imposing only modest incremental liquidity costs. Such a requirement will also avoid pro-cyclicality by preventing the accumulation of large uncollateralized current exposures of the type observed during the recent crisis and during the late 1990's. As the WGMR has observed, the net liquidity impact associated with the exchange of variation margin is not likely to be material in the ordinary course of business because it represents a net transfer of value between derivatives counterparties and is not subject to restrictions on re-hypothecation or re-use.

In contrast, the Consultation's proposal to require the universal two-way exchange of initial margin, on a gross basis and subject to restrictions on re-hypothecation and re-use, would, in addition to raising a number of related concerns and risks, raise significant financial stability concerns due to its associated liquidity impacts. In particular, risk-based initial margin requirements will invariably have a significant pro-cyclical impact in times of market stress, even in circumstances when initial margin requirements are limited in the scope of financial market participants to whom they apply. We must all recognize that future financial shocks are inevitable, and that market resiliency in the face of such shocks must be a pre-eminent and overriding policy objective.

The proposed universal two-way initial margin requirement also goes beyond the measures that are necessary to ensure that interconnected intermediaries have sufficient resources to withstand a major counterparty default without transmitting the resulting losses to third parties. In doing so, we believe the proposal would impose unsustainable strains on liquidity without significant corresponding risk mitigation benefits, and indeed could have potentially destabilizing consequences.

Accordingly, we respectfully recommend below certain modifications to the Consultation's proposals that are intended to align margin requirements with the mitigation of systemic risk, while minimizing adverse liquidity impacts. In particular, we believe it is critical that further consideration and analysis be undertaken with respect to the impact, benefits and potential structure of any initial margin requirements or alternative analogues.[2]

We also provide below a few other targeted recommendations regarding the segregation of initial margin, cross-margining and netting arrangements (should our serious concerns about initial margin be disregarded), eligible collateral for margin, the application of margin requirements to transactions with affiliates, structured finance special purpose vehicles ("**SPVs**"), non-financial end users and sovereign entities, and certain cross-border issues.[3]

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[2] We believe that our recommendations, if adopted, would largely address the concerns raised by SIFMA's Asset Management Group in its comments on the Consultation, as well as those raised by the other letters that we understand are being submitted on behalf of buy-side market participants.

[3] We also agree with the position and supporting arguments presented by the GFMA Global FX Division in their letter to the BCBS and IOSCO Secretariats dated September 28, 2012. In that letter, the Global FX Division recommends exempting deliverable foreign exchange swaps and forwards from any margin regime that requires the exchange, collection or posting, of variation margin or initial margin between transacting parties on a mandatory basis; noting that this market should not be bifurcated based on tenor for the purpose of applying any such mandatory margin regime.

Finally, we recommend that the BCBS and IOSCO publish the quantitative impact study associated with the Consultation, and then provide market participants with the opportunity to provide further comment, before finalizing the Consultation's recommendations. This additional opportunity for public consultation is particularly important in the case of the Consultation because changes to the specific details of the proposal, especially concerning any initial margin requirements, could have significant effects on the overall liquidity and financial stability impacts of the proposal.

II. DISCUSSION

The Consultation identifies as one of two principal objectives of margin requirements for non-centrally-cleared derivatives the promotion of central clearing. We respectfully note that this operating premise is certain to produce inefficiencies and discontinuities that are not offset by financial stability or other social or economic benefits.

The counterparties subject to margin requirements in connection with non-centrally-cleared derivatives are the same counterparties that are subject to mandatory clearing requirements. The most effective way to promote central clearing is directly, through these mandatory clearing requirements. It would be a different matter entirely if counterparties subject to non-cleared-derivative margin requirements did not have to clear derivatives subject to the central clearing mandate.

When a clearing mandate does not apply to a derivative, the cost of disincentivizing the non-centrally-cleared transaction should be carefully considered. Capital requirements already differentiate the perceived differences in risk presented by centrally-cleared versus non-centrally-cleared derivatives. These differences of themselves, together with the multilateral netting benefits of central clearing, create significant incentives for the use of centrally-cleared derivatives.

Counterparties' decisions to incur the greater costs associated with non-centrally-cleared derivatives, whether as a result of incremental risk-based capital or margin costs, reflects an implicit economic evaluation of the significance of the basis risk associated with the use of standardized products to mitigate bespoke risk exposures. The imposition of arbitrary, outsized disincentives, such as heightened confidence intervals that are not rigorously correlated to increased levels of risk or initial margin requirements that impose costs without corresponding incremental risk mitigation benefits, should be avoided.

Such measures would act as mandatory taxes that cannot be avoided by any course of conduct, including a decision not to execute either a centrally-cleared or non-centrally-cleared derivative. However, unlike conventional taxes, they do not achieve demonstrable corresponding social or economic benefits. They may, in fact, prove socially and economically detrimental by increasing systemic risk if they encourage central clearing for instruments that lack sufficient standardization, price transparency or liquidity to be risk managed effectively by central counterparties ("**CCPs**"). Applying punitive margin requirements for non-centrally-cleared derivatives will not help to overcome these obstacles to central clearing.[4]

Another consequence of outsized initial margin requirements for non-centrally-cleared derivatives would be to decrease competition amongst liquidity providers and increase barriers to entry. The higher the level of initial margin that is required, the greater the extent to which market participants will prefer transacting with counterparties with whom they already have larger, established portfolios. A liquidity provider seeking to expand its market share would need to price aggressively enough to outstrip this incentive. At some point, the costs of doing so will be high enough to discourage new entrants and possibly even force the exit of less established market participants.

Moreover, establishing initial margin requirements for non-centrally-cleared derivatives for the purpose of promoting central clearing of swaps, and without regard for the impact on the market for non-centrally-cleared swaps, fails to give due consideration to the significant benefits that non-standardized swaps have provided for many years. These products enable financial and other firms to more effectively hedge their actual risks without incurring exogenous basis risk. The ability to accomplish these results is important. It avoids unnecessary (and actual) financial losses. It also more effectively dampens profit and loss volatility that, in turn, can directly increase an issuer's cost of capital. The imposition of these consequences should not be undertaken lightly and without a careful determination that the corresponding benefits warrant these adverse consequences.

For these reasons, we have focused in our comments below on identifying possible modifications to the Consultation's proposal that are designed to better achieve its principal objective of systemic risk mitigation, while avoiding undesirable collateral consequences.

A. Universal Two-Way Margin

The Consultation notes that a majority of BCBS and IOSCO members support margin requirements that, in principle, would require the two-way mandatory exchange of both initial margin and variation margin between all counterparties to non-centrally-cleared derivatives, with the exception of derivatives with non-financial entities that are not systemically important or with sovereigns or central banks (the Consultation refers to this as "universal two-way margin"). The Consultation then suggests a range of alternative frameworks for defining initial margin thresholds.

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[4] In this regard, it is notable that insufficient market demand has not been an obstacle to continuing efforts to expand clearing beyond interest rate swaps, index credit default swaps ("**CDS**") and single-name corporate CDS to include such products as interest rate swaptions, Western European sovereign CDS, CDS index tranches and foreign exchange options. Rather, tougher obstacles have generally proven to be concerns by CCPs and their regulators about the risks presented by central clearing of these products.

We are concerned that the Consultation's universal two-way margin proposal does not take into account important differences between initial and variation margin, and fails to recognize the potential for universal two-way initial margin to increase pro-cyclicality, as well as credit and other risks. We are very concerned, as a result, that the aggregate liquidity impact of universal two-way margining will both impose significant liquidity costs and have a potentially significant destabilizing impact on the financial system and the real economy. To address these concerns, we suggest that supervisors focus on establishing a robust, two-way variation margin regime, while continuing to evaluate, in consultation with interested constituencies, effective methodologies to further mitigate systemic risk without causing the adverse impacts that would result from mandating the two-way exchange of initial margin.

i. Liquidity Impact of Universal Two-Way Margin

As proposed, universal two-way margin would require the bilateral exchange of initial margin and variation margin on a gross basis across a broad cross-section of participants in the financial markets. The net liquidity impact of regular bilateral exchanges of variation margin is typically not material. This is because, as noted above, variation margin is by definition a net transfer of value and, as a corollary, is not typically subject to restrictions on re-hypothecation or re-use. Rather, variation margin payments can be used to fund other aspects of a collecting party's business, including funding variation margin payments for hedging transactions on the other side of the market.

In contrast, the net reduction in liquidity caused by requiring the exchange of initial margin, on a gross basis and subject to restrictions on re-hypothecation or re-use, would be very substantial. According to an estimate by the International Swaps and Derivatives Association ("**ISDA**"), the liquidity drain associated with the Consultation's proposed initial margin requirements would be approximately US$15.7 trillion.[5] By way of comparison, the total amount of U.S. federal debt currently held by the public is estimated at approximately US$11.25 trillion.[6] The combined balance sheets of the Board of Governors of the Federal Reserve System ("**Federal Reserve**") and the European Central Bank are approximately US$6.7 trillion.[7] This figure also ignores the anticipated liquidity impact of initial margin requirements and guaranty fund contributions for centrally-cleared cleared derivatives, which the International Monetary Fund ("**IMF**") has estimated at approximately US$100-200 billion.[8]

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5 Letter from ISDA to the BCBS and IOSCO Secretariats, dated Sept. 28, 2012 (the "**ISDA Letter**"), at Appendices 1 and 2. Based on ISDA's estimate, even if foreign exchange forwards and swaps were excluded, the liquidity drain would still amount to over US$14 trillion. *See id.*

6 U.S. Bureau of the Public Debt, http://www.treasurydirect.gov/NP/BPDLogin?application=np (last accessed Sept. 27, 2012).

7 Federal Reserve Statistical Release H.4.1 (Sept. 20, 2012); European Central Bank, "Consolidated financial statement of the Eurosystem as at 14 September 2012" (Sept. 18, 2012).

8 IMF, Global Financial Stability Report (April 2012), at p. 96.

One way to estimate the possible liquidity impact of the proposed initial margin requirement is to compare it to other instances involving a sharp decrease in the use/availability of collateral. According to a recent estimate by IMF staff economist Manmohan Singh, the decline in the use/re-use of collateral from 2007 to 2011 was approximately US$4-5 trillion.[9] This decline was roughly equal to the increase in the traditional money supply in the U.S. and Europe over the same period, thereby potentially offsetting the entire monetary stimulus impact of the combined activities of the Federal Reserve, European Central Bank and Bank of England during this time.[10]

Additionally, a shortage of high-quality collateral can have destabilizing behavioral effects. For instance, the IMF recently suggested that the growing demand for safe assets due to prudential measures (including the increased collateralization of derivatives) and central bank operations, combined with a shrinking range of assets perceived as safe, could lead to adverse consequences such as increased short-term volatility jumps, herding behavior, and runs on sovereign debt.[11]

As these considerations suggest, unduly stringent margin requirements can have undesirable economic effects that go beyond direct liquidity costs. As a result, the imposition of requirements that do not afford clear, meaningful and demonstrable financial stability benefits must be avoided.

ii. <u>Macro-prudential Considerations</u>

Initial margin and variation margin also have very different macro-prudential profiles. Variation margin requirements are likely to create desirable macro-prudential outcomes because they ensure that a counterparty will not be required to post a significant amount of collateral for its derivatives when it is suffering significant liquidity strains, thereby preventing the type of significant destabilizing "runs" that were observed during the recent financial crisis. In this way, variation margin requirements prevent the build-up of leverage in good times and soften the systemic impact of subsequent deleveraging. Two-way variation margining on a net basis thus significantly mitigates the need for undesirable pro-cyclical conduct.

Initial margin requirements, in contrast, are unlikely to contribute significantly to financial stability and, indeed, may have destabilizing pro-cyclical effects. To be risk sensitive, initial margin models are typically dynamic, adjusting based on prevailing levels of market volatility and liquidity. One recent study estimated that initial margin requirements for centrally-cleared derivatives could increase almost three-fold for interest rate swaps and more than ten-fold for CDS by moving from a modeling scenario based on stable market conditions to one that

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9 Manmohan Singh, "The (Other) Deleveraging," IMF Working Paper 12/179 (July 2012), at p. 15.

10 *Id.* at p. 14 (noting that a "shortage of acceptable collateral would have a negative cascading impact on lending similar to the impact on the money supply of a reduction in the monetary base").

11 IMF, *supra* Note 8, at p. 81.

is based on conditions of market stress.[12] The authors of that study also observed that the liquidity drain associated with increased initial margin requirements in conditions of increasing volatility are likely to create a pro-cyclical feedback loop, as calls for additional collateral force market participants to unwind positions, thereby potentially exacerbating volatility and, as a result, initial margin requirements.[13]

In contrast to centrally-cleared derivatives, non-centrally-cleared derivatives have no central supervisory body, such as a CCP risk committee or global supervisor, to dampen the process where necessary. Rather, decentralized market participants, each complying with their own regulatory and internal corporate mandates, would serve as vectors for propagating (and amplifying) this pro-cyclical feedback loop across markets and across borders.

The Consultation seeks to address these issues by noting that "margin levels should be sufficiently conservative to avoid pro-cyclicality, even during periods of low market volatility" and that the "specific requirement that initial margin be set consistent with a period of stress is meant to limit pro-cyclical changes in the amount of initial margin required."[14] Due to the aggregate liquidity strains and undesirable economic effects noted above, however, one may question whether this "solution" is worse than the problem, since increasing initial margin levels by calibrating them to historically high volatility levels at the outset would simply imply a permanent state of unsustainably high demand for high-quality collateral and stress on available money supply.[15] Even these assumptions, however, would not counter the invariable and significant demand on liquidity that would result from the need to meet initial margin increases in an environment of extreme market stress, when market and participant resiliency is the most important objective.

iii. Credit Risk Impact of Universal Two-Way Margin

As in the case of their respective liquidity impacts and macro-prudential profiles, initial and variation margin also present different credit risk profiles. Variation margin is designed to cover a counterparty's actual current exposure, *i.e.*, its net mark-to-market exposure at a point in time. Exchanging variation margin can be expected to mitigate systemic risk by reducing the contagion and spillover effects that result when a derivatives counterparty defaults while owing a substantial amount to its counterparty on a current, mark-to-market basis.

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[12] Daniel Heller and Nicholas Vause, "Collateral Requirements for Mandatory Central Clearing of Over-the-Counter Derivatives," BIS Working Paper No. 373 (Mar. 2012), at p. 20.

[13] Heller and Vause, "Expansion of Central Clearing," BIS Quarterly Review (June 2011), at p. 77.

[14] Consultation, at p. 19.

[15] Use of standardized initial margin calculations, while also avoiding pro-cyclicality, similarly would generate a demand for high-quality collateral that is simply not sustainable. *See* ISDA Letter, at Appendix 1 (estimating that the drain on liquidity if the market was required to rely on the Consultation's proposed standard tables to be approximately US$29.9 trillion).

Initial margin, on the other hand, is intended to cover the potential increase in mark-to-market exposure over a defined period of time following default. As a result, initial margin inherently imposes some degree of over-collateralization relative to current exposure. Consequently, on a current basis, initial margin presents the posting party with credit risk to the collecting party for the return of the margin it has posted.[16] This overcollateralization effect is, almost by definition, more than doubled in the case of derivatives intermediaries who have largely matched derivatives dealing books, even though it is a certainty that the derivatives intermediary cannot incur losses (and present a credit risk) on both of the offsetting derivatives positions.

In addition to this overcollateralization effect, the bilateral exchange of initial margin requires a comparison of the direct and indirect benefits of protecting the collecting party from potential adverse mark-to-market movements following the posting party's default against the direct and indirect costs of exposing the posting party to the risk that its initial margin will not be returned following the collecting party's default.[17] Whether requiring initial margin in a particular case will increase or mitigate credit risk depends on whether the defaulting party is the posting party or the collecting party, respectively, a fact that is unknowable *ex ante*. Thus, to require initial margin is to decide that the benefits of mitigating *potential future* credit exposure outweigh the creation of *current* exposure. Moreover, requiring a two-way exchange of initial margin will, by definition, increase credit risk in the system because both parties cannot each simultaneously default while owing the other money.

The Consultation implicitly recognizes these issues by proposing that initial margin be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law. However, segregation arrangements introduce their own complications, costs and risks, whether they are inherent differences in the motivations of the parties (in the case of tri-party custody) or inconsistencies in applicable client asset protection regimes (in the case of segregation on the balance sheet of the initial margin receiver).

Accordingly, while it may seem intuitive that more initial margin equates to greater systemic safety, in truth the risk mitigation benefits of expanding the collection of initial margin are at best ambiguous.

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16 This is implicit in capital requirements applicable to securities firms in the U.S., which, as the Consultation notes, require the firm to treat assets that are delivered by it as margin collateral to another party as unsecured receivables from the party holding the collateral to be deducted in full when calculating the firm's net capital. *See* Consultation at p. 3.

17 The existence of any benefits requires that the initial margin arrangement is legally enforceable. In some jurisdictions, the legal enforceability of rights against initial margin is not clear. Naturally, requiring initial margin to be posted when it may not be foreclosed upon by the collecting party would have no risk mitigation benefits.

iv. Analogy to the Centrally-Cleared Derivatives Market

The Consultation suggests that requiring the two-way exchange of the full amount of initial and variation margin would promote consistency with central clearing mandates. In our view, this suggestion is based on two incorrect premises: that margin requirements for non-centrally-cleared derivatives should be used to promote central clearing, and that requiring a two-way exchange of both initial and variation margins for non-centrally-cleared derivatives would simply mirror the application of margin requirements for centrally-cleared derivatives.

As a threshold matter, requiring the two-way exchange of initial margin is not necessary to promote central clearing. Under the G-20 reform program, all derivatives that are sufficiently standardized and liquid to support widespread central clearing would become subject to a clearing mandate. As noted above, calibrating margin requirements beyond a risk-appropriate level to promote central clearing other than in circumstances required by the clearing mandate would result in uneconomic decision-making and could drive derivatives into central clearing before they have the requisite level of standardization, price transparency or liquidity. Doing so may also force market participants to accept basis risk by unduly increasing the costs of non-standardized derivatives. Imposing high costs on market participants to enter into non-centrally-cleared derivatives, especially when they do not have a cost-effective or risk-correlated centrally-cleared substitute, will discourage market participants from reducing their risk (and risks to the financial system) because the direct and indirect costs outweigh the risk-reducing advantages. These results would not be beneficial from either a systemic risk mitigation or economic efficiency perspective.

Additionally, the Consultation's analogy between two-way margin for centrally-cleared and non-centrally-cleared derivatives is flawed because it ignores the role of the CCP. For centrally-cleared derivatives, there is a two-way exchange of variation margin on a net basis: if a member is out-of-the-money on its positions, it will pay variation margin to the CCP and, if it is in-the-money, the CCP will pay variation margin to it. In contrast, there has never been a requirement that a CCP post initial margin to its clearing members. Doing so would increase the credit risk profile of the CCP. It also would indirectly increase the credit risk profile of the market as a whole by exposing all CCP members to the risk that the CCP might incur losses due to the loss of initial margin it has posted to a defaulting member.

The reason for this distinction is that one participant in the market (the CCP) is interconnected and serves as the vector for the transmission of risk to all the other participants. Bolstering the safety and soundness of the CCP generally benefits the market as a whole. Accordingly, CCPs are required to have adequate resources available to absorb the potential losses arising from member defaults, so that those losses do not lead to cascading defaults throughout the overall system. Initial margin is one of those resources. Other default resources can include the CCP's capital, its default guarantee fund and member assessment rights.

Similar considerations apply to the market for non-centrally-cleared derivatives. Some participants in that market are more interconnected than others. One way to distinguish these participants is based on the role they play in the market. For instance, because they are in the business of providing liquidity, rather than taking directional risk, dealers, market makers and other derivatives market intermediaries naturally transact with more parties (and more non-dealer parties) than other market participants. Such intermediaries are also typically subject to prudential supervision, including capital requirements.[18] To the extent that they are also subject to prudential supervision, systemically important non-intermediary participants in the derivatives markets should be treated in a manner similar to the treatment of derivatives intermediaries.[19]

By the nature of their regulation, interconnected intermediaries in the market for non-centrally-cleared derivatives are, like CCPs, subject to strict risk management requirements and must maintain a cushion of resources to absorb losses from a defaulting counterparty without transmitting them to their other counterparties. They are also similar to CCPs in that exposing these financial intermediaries to credit risk by requiring them to post initial margin indirectly increases the risk profile of the other financial market participants who have credit exposure to them.

v. <u>Relationship between Margin and Capital</u>

While intermediaries in the non-centrally-cleared derivatives markets are similar to CCPs in the ways noted above, they differ from CCPs in the composition and extent of default resources available to them. CCPs have relatively little capital, and so their creditworthiness depends on the initial margin that they collect. Derivatives market intermediaries, on the other hand, tend to have much larger capital bases, which are subject to regulatory minimums. They are also commonly subject to minimum requirements for the maintenance of liquid assets. Both these capital and liquidity requirements are in the process of further refinement and enhancement. In light of these additional resources, it is not necessary in our view to require derivatives market intermediaries to collect initial margin.

The Consultation accurately notes that capital and margin serve different objectives and therefore are not complete and fungible substitutes for each other. At the same time, capital levels can nonetheless be calibrated to address the systemic risk implications of a decision by a prudentially regulated entity to forego collection of defined levels of initial margin.[20] In addition, enhanced liquidity requirements can, like a default guarantee fund, help to

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18 A recent IOSCO report recommends that derivatives market intermediaries be subject to capital and margin requirements. *See* IOSCO, "International Standards for Derivatives Market Intermediary Regulation" (June 2012) at p. 16 (noting that, "maintenance of adequate capital standards by DMIs and the imposition of appropriate margin requirements to OTC derivatives transactions involving DMIs are essential mechanisms to better ensuring that OTC derivatives markets operate soundly").

19 An example of this would be major swap participants under the U.S. Dodd-Frank Act.

20 Indeed, as noted above, post-Basel III, capital requirements for non-centrally-cleared derivatives can be expected to be significantly more robust, across many dimensions, than the capital requirements in effect during the recent credit crisis.

assure that an intermediary has adequate liquid resources on hand to satisfy the demands on it during a post-default period over which it is not collecting variation margin.

Margin and capital (and other prudential requirements) are not only relevant in determining when a regulated intermediary should collect initial margin (and how much). They also are relevant in determining when such an entity should post initial margin (and how much). The corollary to the observation that derivatives market intermediaries have more resources in the form of capital and liquidity buffers to absorb losses is that they are less likely to default. That they are subject to comprehensive and direct safety and soundness supervision, beyond capital and liquidity requirements, also contributes to this risk mitigation effect.

We are concerned, however, that the Consultation, to our minds counter-intuitively, proposes that prudentially supervised intermediaries should be subject to heightened obligations to post initial margin when trading with unregulated counterparties. Such a requirement would be inconsistent with the premise that margin levels should reflect differentials in creditworthiness, and would call into question the efficacy of capital and related safety and soundness requirements as a means for assuring the financial safety of financial institutions.

A universal two-way initial margin exchange regime also fails to take into account the transaction cost differentials associated with the application of capital requirements to prudentially supervised derivatives intermediaries. Prudentially supervised derivatives intermediaries must maintain significantly higher amounts of capital to support their derivatives activities than unregulated entities, including transaction-specific capital costs. The cost of such capital requirements should be factored into the consideration of any regime that would differentiate between market participants on the basis of their regulatory status.

In this regard, we note that some have raised the concern that a one-way initial margin collection obligation that applies only to derivatives intermediaries vis-à-vis their unregulated counterparties could advantage regulated intermediaries that collect initial margin at the expense of unregulated entities that post initial margin. We believe that this concern is misplaced for a number of reasons, in addition to the capital costs noted above.

In any given transaction, an intermediary and its non-intermediary counterparty are not competing with each other in any normal sense of the word. One is providing liquidity – and in so doing seeking to profit from the bid-ask spread – and the other is taking liquidity – and in so doing seeking to profit from expected future price variations (or to lock in a profit from such variations). They are not pursuing the same profit opportunity, but rather each party's profitability depends on the existence of the other.

Moreover, solely comparing the relative positions of an intermediary and its non-intermediary counterparty on a given trade ignores the fact that, for the intermediary, the risk of that trade must be offset by other transactions in the market. When the intermediary hedges its risk, it must either go to another intermediary, or it must execute a centrally-cleared transaction. In either case, if initial margin is required to be collected by derivatives market intermediaries, the hedging intermediary will be subject to an obligation to post initial margin. Its non-intermediary counterparty, on the other hand, may well simply maintain its directional position without incurring any equivalent additional cost.

When viewed from the perspective of an intermediary and a non-intermediary financial entity that are competing independently for a transaction in the market with third parties (rather than with each other), each must find a liquidity provider counterparty that will be regulated as an intermediary and both the non-intermediary and the intermediary would be required to post initial margin to their intermediary counterparties. There is, as a result, only the most superficial, and clearly no substantive asymmetry, in a regime in which only prudentially supervised derivatives market intermediaries are subject to margin collection obligations.

vi. Suggested Approach

For the reasons set forth above, we support a robust, two-way variation margin regime. However, we believe that additional study and consultation is needed before adopting an initial margin regime, which as we have noted, would raise serious concerns.

Requiring (on a phased-in basis) the daily exchange of variation margin between all financial entities (other than qualifying SPVs, as noted below) and systemically significant non-financial entities, with zero thresholds and subject only to low minimum transfer amounts, would largely address many of the systemic risk and macro-prudential concerns associated with non-centrally-cleared derivatives. To bolster this regime, we also support improvements to the valuation infrastructure upon which variation margining depends, including requirements for regular portfolio reconciliation, dispute resolution and the reporting of material valuation disputes to supervisors.[21] Regulatory authorities may also wish to consider phasing in a shortening of the interval between the occurrence of a failure to make a variation margin payment and the time at which the non-defaulting party may initiate liquidation of the defaulting counterparty's portfolio.

This variation margin regime would be a significant improvement over the status quo, preventing the types of destabilizing, pro-cyclical "runs" that have occurred in the past, when variation margin collection was either waived or subject to ratings-based triggers. It would also bring the non-centrally-cleared derivatives market overall in line with other markets, such as foreign exchange and repo, where initial margin is not generally considered to be necessary.

Implementing rigorous, two-way daily exchange of variation margin will, however, take time. Not all participants in the market currently exchange variation margin, and requiring margin to be exchanged on a daily basis will require many participants to make substantial operational adjustments. Documents will need to be negotiated or renegotiated, enhanced valuation methodologies developed, and operational systems modified. To facilitate the implementation of these adjustments in an orderly manner, we suggest that authorities

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[21] We note that these requirements were recently adopted by the U.S. CFTC under the Dodd-Frank Act, and also have been proposed by European supervisory authorities under the European Market Infrastructure Regulation.

provide 18 months from the publication of final rules until universal two-way daily variation margining is required for non-centrally-cleared derivatives between financial entities (other than qualifying SPVs) and systemically important non-financial entities located in G-20 jurisdictions,[22] with a shorter phase-in period for non-centrally cleared derivatives between derivatives market intermediaries.[23]

In the case of initial margin requirements – in particular, universal two-way initial margin – we have very serious concerns that the negative liquidity, pro-cyclicality, and credit and custodial risk consequences described above would outweigh any incremental benefit from the reduction of systemic risk. In preparing this letter, we set out to develop recommendations for a modified initial margin regime that would strengthen systemic resiliency while addressing these concerns. After evaluating a number of proposals, however, we determined that the best approach, at this time, would be to focus first on expanding and improving on the exchange of variation margin, as described above. This prioritization would give regulators an additional period to observe the market, identify risks that are not addressed by a variation margin regime, and consider other possible measures, which may include initial margin requirements.

We therefore recommend that the WGMR continue to study alternatives to the universal two-way exchange of initial margin and consult further with the public. For this exercise, all options should be on the table, including: (i) bolstering forms of loss absorption other than initial margin or designing new ones; (ii) narrowing the range of counterparty pairs that must exchange initial margin (or the range of market participants that must collect initial margin) so that initial margin requirements apply only when they are most likely to reduce interconnectedness; (iii) calibrating thresholds to mitigate liquidity impacts and credit/operational risks to interconnected intermediaries; and (iv) modifying the methodology for calculating initial margin amounts, including adjusting the confidence interval and/or liquidation horizon. In the meantime, whether market participants post initial margin should be a matter of bilateral negotiation, based on their own evaluation of the costs and risks and prudential safety and soundness considerations, where applicable.

B. <u>Other Requirements</u>

In addition to the proposal for universal two-way margin, the Consultation addresses a number of additional requirements relevant to the design of a margin regime, including initial margin requirements. As we have explained above, we believe strongly that initial margin requirements as outlined in the Consultation would not increase systemic resiliency and may induce systemic instability through the uncontrolled propagation of over-

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22 Additional time may be necessary for market participants in other jurisdictions to establish necessary infrastructure.

23 Here, we use the term "derivatives market intermediary" in the same sense as the recent IOSCO report. *See* Note 18, *supra*. We also include systemically important non-intermediary participants in the derivatives markets that are subjected to prudential supervision.

collateralization through the system via the vector of pro-cyclical risk-based initial margin requirements. Notwithstanding this over-arching concern, we have offered below further observations and considerations that market participants and regulators should consider in designing a margin regime.

i. Segregation of Initial Margin

The majority of the WGMR participants support requiring parties to fully segregate initial margin and prohibit re-hypothecation or re-use of cash or non-cash initial margin posted for non-centrally-cleared derivatives. We agree that initial margin, as a form of over-collateralization, creates additional current credit risk that in many cases parties may wish to mitigate through segregation, which protects the posting party in the event of a default or insolvency of the collecting party.

Each method of segregation, however, comes with its own costs and risks. Segregation on the balance sheet of the initial margin receiver is a viable solution in some jurisdictions that have an appropriate client asset protection regime in place, but this excludes many countries and even those jurisdictions that have inconsistent regimes. In this regard, an internationally consistent regime for protection of segregated collateral might be a useful tool for regulators to develop.

In the same way that segregation on balance sheet is not a straightforward decision, mandatory protection of initial margin through tri-party custodial arrangements may not be the preferred option for all counterparties. The costs, execution and administration of control agreements, and additional complexity inherent to such arrangements are factors that may make such arrangements more appropriate for some circumstances than others. In a tri-party arrangement, the three entities involved must attempt to balance the different considerations that each will have: the pledgor of initial margin sees the arrangement as presenting over-collateralization risk and wants the collateral to be tightly protected; the receiver of initial margin wants unrestricted access to the collateral if a default occurs; and the custodian seeks clarity about if and when to release the collateral, and to which party, in a variety of complex circumstances. Additionally, there are a very small number of non-affiliated global custodians in the world. While this presents no particular issues where the amount of collateral held in tri-party arrangements is relatively small, such as in the current market structure, there would be concerns if regulators were to impose a more widespread initial margin regime where the quantum of initial margin were very much greater. Implementation timing should factor in facilitating technological developments with custodians, in addition to negotiating and executing the requisite documentation.

To be clear, segregation on-balance-sheet can be a useful tool and custodial banks provide valuable tri-party services that provide a solution in many cases, but the analysis is complex and unique to each counterparty situation. There is thus no “one size fits all” solution.

For these reasons, we believe that, whether initial margin is required to be collected or merely provided as the result of bilateral negotiations, a party collecting initial margin should be required to offer a range of segregation arrangements.[24] Based on its consideration of its counterparty's creditworthiness and the relative costs and risks of segregation arrangements, a party posting initial margin should be permitted to elect among any of three options: (i) permitting the collecting party to hold the margin without restriction on re-hypothecation or re-use; (ii) permitting the collecting party to hold the margin, but require that it be segregated from the collecting party's proprietary assets, subject to restrictions on re-hypothecation or re-use and subject to a first priority claim by posting entities in the collecting party's insolvency (so that segregated cash, securities and other assets would only be available to meet redelivery claims of swaps counterparties, but not claims of general creditors);[25] or (iii) requiring initial margin to be held, at the posting party's expense, by a third-party custodian.

ii. <u>Cross-Margining and Netting</u>

Under the Consultation, quantitative initial margin models would be permitted to account for risk on a portfolio basis, but only taking into account those derivatives approved for model use that are subject to a single, legally enforceable netting agreement. In our view, this proposal is unduly restrictive because it would appear to prohibit the effective use of cross-margining arrangements, even when they are legally enforceable.

We do not believe that this restriction is consistent with the overall principles underlying the Consultation. In particular, one of the seven key principles for the overall Consultation is that "[r]egulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions."[26] While we believe that this principle is intended to apply to cross-border considerations, it is equally applicable to cross-product considerations. The proposed requirements for minimum margin requirements on non-centrally-cleared derivatives as further discussed in the Consultation contradict this principle. Determining a minimum margin requirement for non-centrally-cleared derivatives without taking into account any hedges within the other portions of the portfolio in essence would result in duplicative initial margin for what is essentially the same risk in a well-balanced portfolio.

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[24] If initial margin is required to be exchanged by both parties, then it would be necessary to require its segregation (in one form or another) to effectuate the overall initial margin regime. This is, in our view, another reason why universal two-way initial margin would be inappropriate. It inherently raises additional risks that require the adoption of additional protections that, in turn, raise their own issues.

[25] This arrangement would be analogous to the type of protections applicable in the cash securities and centrally-cleared derivatives markets. *See, e.g.* U.S. SEC Rule 15c3-3 (securities customer protection rule); U.S. CFTC Rules 1.20 and 1.25 (futures customer segregation rules). Combined with robust capital requirements, this type of arrangement would make it likely that, if the collecting party were to fail, segregated property would be readily available to be returned to the posting party.

[26] Consultation, at p. 4.

By way of example, one context where a restriction on portfolio-based cross-margining arrangements is likely to give rise to unnecessary adverse consequences involves cross-margining between centrally-cleared and non-centrally-cleared derivatives. Clearing mandates will necessarily force the break-up of netting sets by requiring that some classes of derivatives be centrally cleared while others remain subject to bilateral netting agreements. Imposing separate initial margin requirements to both netting sets would significantly increase the liquidity impact associated with those requirements.

To address these issues, market participants have developed arrangements for cross-margining centrally-cleared and non-centrally-cleared derivatives. Under these arrangements, the total initial margin would be calculated based on the risks of both centrally-cleared and non-centrally-cleared derivative portfolios. Although this will result in a lower total initial margin requirement, it will more accurately reflect the risk of default on a portfolio basis. The CCP would receive the full amount of initial margin to which it is entitled and the non-centrally-cleared derivative counterparty would receive the remainder. In an event of default, the CCP and clearing broker would be paid in full with the initial margin they hold and any excess margin would be available (subject to the prior claims of the CCP, clearing brokers and customers) to satisfy the claim of the non-centrally-cleared derivative counterparty. These arrangements have been in place for years to establish cross-margining between futures contracts and OTC derivatives, and have proven to be an effective mechanism for calibrating margin requirements to reflect accurately the overall risk presented by a counterparty's portfolio. Similar arrangements are also commonly used in other areas, such as to cross-margin derivatives and correlated cash positions (margin loans and short positions in prime brokerage arrangements), listed options, repo and/or securities lending positions.

The permissibility of these arrangements should, of course, be premised on their legal enforceability. Again for example, in the case of a clearing broker's ability to apply portfolio-based cross-margining requirements across cleared and non-cleared trades, we believe that the determining factor of what requirements are applicable should turn on whether the clearing broker has executed a legally enforceable master netting agreement with its customer. The presence of a legally enforceable master netting agreement creates additional risk mitigants and protections against undesirable clearing broker-specific or systemic effects that could result from a customer default.

These protections, embedded in the master netting agreement, include: (i) cross default and close-out netting upon the occurrence of a customer default; (ii) mechanics that allow for dynamic margin calculations that reflect real portfolio risk; (iii) ability to apply excess clearing house collateral, following a customer default, against amounts owed by a customer to the clearing broker pursuant to non-centrally-cleared transactions; and (iv) in the case of cross-entity master agreements, the ability to apply receivables collateral owed to the customer against amounts owed by the customer to the clearing broker. For these reasons, we believe that, if a clearing broker has executed a legally enforceable master netting agreement, then a more capital-efficient, risk-based portfolio margin requirement across a broader range of cleared and non-cleared positions should be permitted.

In addition, the Consultation proposes that "initial margin models may account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit and commodities, but not across such asset classes."[27] This proposal would create artificial distinctions depending on asset class categorization, which for non-standardized derivatives can be quite challenging and in some cases arbitrary. It is not necessary to make these distinctions in the abstract because initial margin models will, in any event, be subject to approval by a prudential supervisor.

To address these issues, we recommend that, if initial margin requirements are imposed, the WGMR modify its proposal to permit initial margin models to account for risk on a portfolio basis, taking into consideration offsets between all instruments subject to legally enforceable cross-margining or netting arrangements and supervisory approval of the model's correlation assumptions.

iii. Eligible Collateral

The Consultation proposes key principles that collateral must satisfy to be eligible for initial and variation margin and does not limit eligible collateral to a narrow category of assets. We support the WGMR's flexible approach to determining eligible collateral. There are many factors that should be considered in determining what collateral should be accepted for each unique counterparty and trade. The collateral's liquidity, exposure to credit, market and foreign exchange risk, correlation with a counterparty's creditworthiness and the underlying derivatives portfolio as well as diversification are key considerations in such determinations.

The opposite approach of specifying a limited category of assets that can be used as margin for non-centrally cleared derivatives increases market participants' risk by requiring them to accept collateral that is inappropriate in many situations. It also increases costs and liquidity pressures on market participants by increasing demand for and placing undue pressure on the supply of such collateral. A fixed set of eligible assets is additionally likely to be unresponsive to future market evolution and the idiosyncratic needs of counterparties with particular asset portfolios or those in emerging markets.

For these reasons, we strongly urge BCBS and IOSCO members to maintain the principles-based approach described by the Consultation when implementing international standards through national rulemakings. At a minimum, national implementing rules should permit a range of eligible collateral at least as broad as the range of eligible financial collateral under Basel capital rules.

Additionally, we note that the table shown in Appendix 2 of the Consultation proposes that cash collateral in a different currency to the underlying exposure would attract an 8% haircut. We believe that some haircut is warranted when there is no management of the risk between the exposure currency and the collateral currency, although an 8% haircut is likely

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[27] Consultation, at p. 18.

excessive given historical volatilities over the short (typically 1-day) period between margin calls. However, when the parties have in place a specific agreement under which this cross-currency risk is managed, no haircut should apply. We refer specifically to the ISDA Standard Credit Support Annex ("**SCSA**"), which is under development and should be released for use in October of 2012. This new collateral agreement improves upon and addresses many issues observed with the original credit support annex, and has been widely discussed with (and encouraged by) international supervisors. It has been developed at the request of market participants and also in consideration of suggestions from the OTC Derivatives Supervisors Group following the recent financial crisis that it may be appropriate to review and update the existing credit support annex documents.

The SCSA computes a collateral requirement in the currency of each underlying exposure in a bilateral portfolio, thus ensuring alignment of collateral and exposure currency. Rather than calling for settlement of each collateral currency individually, which would introduce significant cross-currency settlement risk to the market, the SCSA instead calls for net settlement of the different currencies of collateral in a single "Transport Currency." This Transport Currency represents the aggregation of the underlying collateral currencies, but their underlying character is preserved because the SCSA requires interest to be accrued based on the underlying collateral currencies (meaning that the Transport Currency used to avoid cross-currency settlement is converted back to each underlying collateral currency so that it can accrue interest). The SCSA also calls for execution of foreign exchange swap transactions or other measures to actively hedge the currency risk between the Transport Currency and the underlying collateral currencies. It is critical to this important industry development that exposure-aligned, foreign exchange-risk-managed cash collateral under the SCSA not be subject to any haircut.

This is entirely consistent with the underlying thinking behind the haircut in Appendix 2, but expressed in generalized form. Allowing the SCSA to qualify for no cross-currency risk haircut would also provide an avenue to market participants to maintain collateral efficiency without resorting to the highly dangerous practice of settling each currency of collateral independently, which would be the functional equivalent of Herstatt risk in the foreign exchange market but on a far wider and more complex scale.

iv. Transactions with Affiliates

There was general consensus among the BCBS and IOSCO on a compromise approach pursuant to which non-centrally-cleared derivatives between affiliated entities would be subject to variation margin requirements, but with initial margin requirements left to national discretion. We recommend instead that inter-affiliate transactions be excluded from initial margin requirements entirely (should they be adopted in the first place), and that variation margin collection requirements should apply only to a regulated derivatives market intermediary when it is transacting with an unregulated affiliate.

Inter-affiliate transactions also enable improved hedging efficiencies and better facilitation of transactions with customers (*e.g.*, customers can transact with a single entity in their jurisdiction). Additionally, global financial entities typically centralize their market risk exposures through a series of back-to-back transactions. Centralizing this exposure allows firms to more effectively manage their risk by aggregating and netting portfolio and other risk offsets before hedging their exposure in the market. Imposing excessive margin requirements on inter-affiliate trades would discourage these prudent risk-reducing techniques because the costs of allocating margin could outweigh the benefits gained from posting margin. Posting and collecting margin would also raise complicated cross-border operational issues and cost allocations.

There are also other mitigants to the risks of inter-affiliate transactions that are less disruptive. In particular, regulated derivatives market intermediaries must hold capital against exposures to their affiliates. In addition, financial holding company groups are typically subject to consolidated supervision and risk management requirements, and holding companies may even be required to serve as a source of strength to their regulated subsidiaries.

Nevertheless, there is one circumstance where a build-up of current exposure by one affiliate to another could be a significant cause for concern: where a regulated derivatives market intermediary has significant credit exposure to an unregulated affiliate. In such a case, the regulated affiliate's uncollateralized current exposure might pose a risk to third parties transacting with the regulated affiliate without that risk being addressed through effective prudential supervision of the affiliate. Accordingly, we believe it would be appropriate in these circumstances to require the regulated derivatives market intermediary to collect variation margin from the unregulated affiliate.

v. <u>Transactions with Structured Finance SPVs</u>

Non-centrally-cleared derivatives with structured finance or securitization SPVs are subject to additional considerations not presented in the context of other types of transactions. In a typical structure, an SPV issues debt that is supported by a pool of assets that serves as collateral for the debt, which is usually over-collateralized. Whether to hedge interest or foreign exchange risk, or to gain market- or credit-linked exposure, the SPV might enter into one or more derivatives. However, because the SPV is generally capitalized to the extent of its obligations, and does not have an operating business to generate free cash flow, it is not able to post variation margin, much less initial margin, to its derivatives counterparty. Instead, the derivatives counterparty typically has rights as a senior secured creditor, and the assets of the SPV are used first to pay for the SPV's derivatives obligations. This arrangement has generally proven to be an effective way for the counterparty to manage its risk to the SPV. In contrast, subjecting the SPV to margin requirements would essentially prevent it from entering into any derivatives at all. Accordingly, where the above alternative security arrangements are in place, derivatives with a structured finance or securitization SPV should be excluded from margin requirements.

vi. Transactions with Non-Financial End Users, Sovereigns and Central Banks

The BCBS and IOSCO have expressed broad support for exceptions from margin requirements for non-centrally-cleared derivatives with non-financial entities that are not systemically important and with sovereigns and central banks. We also support these exceptions. Transactions with these entities do not generally pose the type of risks to the safety and soundness of derivatives market intermediaries that would justify the categorical application of margin requirements to them. Additionally, for sovereigns and central banks, applying margin requirements would raise significant international comity issues because foreign regulators would be effectively limiting the credit available to foreign sovereigns in order to support their local financial entities. There are also numerous practical impediments to foreign sovereigns pledging assets, such as negative pledge restrictions imposed by multilateral lending institutions (*e.g.*, the World Bank) and the need for legislative action to pledge assets.

vii. Cross-Border Issues

We strongly support international harmonization of margin requirements for non-centrally-cleared derivatives.[28] The potential adverse consequences of inconsistent or conflicting rules would be highly significant, undermining the efficacy of margin requirements, creating competitive disparities and, for transactions between entities subject to conflicting regimes, effectively prohibiting transactions entirely. The Consultation is a critical step toward avoiding these consequences.

In this regard, we also support the Consultation's proposal for home-country supervisors to permit a covered entity to comply with the margin requirements of a host-country margin regime with respect to its derivative activities, so long as the home-country supervisor considers the host-country margin regime to be consistent with the proposed margin requirements described in the Consultation. However, we urge the WGMR to reconsider its proposal that a branch should be subject to the margin requirements of the jurisdiction where its headquarters is established. We also urge the WGMR to reconsider its proposal to apply the more "stringent" of the home/host jurisdiction's margin requirements when they are "different."

There should be a level playing field in each jurisdiction, and this can only be achieved by applying the host jurisdiction's margin requirements (including for local branches of foreign banks) so long as they are consistent with international standards. Imposing the more stringent of the home/host requirements will create competitive imbalances amongst parties competing for the same business. Moreover, applying the more "stringent" of two sets of different requirements will not avoid the untenable results that will occur if the contracting parties are each located in a different jurisdiction that applies different rules. In those cases, using such a loose standard to determine which rules will apply will lead to significant

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28 Such harmonization should, in our view, include not only the extent of the requirements themselves, but also the scope of instruments and market participants that they cover.

uncertainty. Furthermore, it is likely that neither the home nor host country's margin requirements will be the most stringent in every respect. The home country might have the more stringent margin threshold requirements whereas the host country may have the most stringent eligible collateral requirements. Who will make the determination that one of the regimes, in its entirety, is the most stringent? Requiring such determinations will lead to significant uncertainty and conflicts between regulators. It is far better to strive for the greatest degree of international consistency that is feasible.

If initial margin is required, another important cross-border issue would arise in cases where an initial margin model approved by a supervisor in one jurisdiction may be used in another jurisdiction. The Consultation states that there will be no presumption that approval by one supervisor in the case of one or more institutions will imply approval for a wider set of jurisdictions and/or institutions. We recommend, however, that an exception to this principle be adopted in the case of the subsidiary of a holding company subject to consolidated supervision where the initial margin model to be used by the subsidiary has been approved by the subsidiary's consolidated supervisor, provided that that consolidated supervisor has adopted requirements for model supervision consistent with international standards.

This exception is important because initial margin is related to capital. Models used to compute the potential market, and resulting credit, risks associated with derivatives positions must model these risks in a manner that is consistent with the modeling of these risks for capital computation purposes. As a result, it is critical that initial margin and capital requirements be administered within a consistent supervisory framework. This is particularly the case where the same modeling techniques or the same models are used for computing both capital charges and initial margin amounts. In those circumstances, the same regulator should be responsible for the requirements applicable to, and the review and assessment of, those models for purposes of both capital and margin requirements. The use of different, and separately supervised, models for capital and margin purposes could give rise to unidentified risks or capital inefficiencies.

III. CONCLUSION

Margin rules will not operate in isolation; they must be considered within the context of other new regulations that are intended to reduce the risks associated with the interconnectedness of systemically important financial institutions. Higher and better-quality capital requirements, proposed liquidity restrictions, existing and (in the U.S.) proposed limits on single counterparty credit exposures are all intended to improve systemic resiliency and reduce the risk that a single failure will spiral into a broader crisis. In fact, as noted above, both margin rules and counterparty exposure limits address counterparty risk, and so should not be written or implemented as independent requirements.

Many of these regulatory efforts are currently being pursued in isolation, running the risk that even the best-intentioned proposals may inadvertently create a regulatory burden that reduces market liquidity, raises transaction costs for end-users and ultimately limits the supply of credit to the real economy. It is important that regulators calibrate each of these requirements in the context of multiple, overlapping sets of rules. It is also important that they base new regulations on appropriate and accurate measurements of risk.

Given the uncertainty surrounding national implementations of Basel III, the as-yet-unresolved issues regarding liquidity ratios and the challenges of appropriately calibrating single counterparty credit limits, we believe it is premature to add a new set of margin regulations that are themselves designed to comprehensively address the problem of interconnectedness. In our view, it would be more appropriate to incorporate margin rules as part of counterparty rules, while considering the implications of the capital and liquidity rules as well. We believe it would also be appropriate to allow regulators and interested constituencies to assess the effectiveness and cost of these other regulations, both individually and together, before moving ahead with global initial margin rules.

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We would be pleased to provide further information or assistance at the request of the WGMR. Please do not hesitate to contact the undersigned, or Edward J. Rosen (+1 212 225 2820) or Colin D. Lloyd (+1 212 225 2809) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to SIFMA, if you should have any questions with regard to the foregoing.

Respectfully submitted,

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